



Do Provision for Non-Audit Services (NAS) Give Rise to Audit Fees

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Abstract

Throughout the years, auditing field has experienced tremendous change, but in Malaysia, the charged fees are still found to be the lowest in Asean countries. Literatures forwarded non-audit services among others as being influential to audit fees. Thus, this study aims at exploring the significant of non-audit services in charting audit fees in Malaysia. 100 public listed companies were surveyed comparing their non-audit service (NAS) they used and reasons, auditees complexity, auditees risk, auditor's opinion, auditees size and audit fees. Findings indicated that NAS is insignificant to audit fees charged in Malaysia.

Keywords: Non-Audit Service; Audit Fees; Audit Disclosure, Auditees Size, Auditees Complexity.

1. Introduction

Non audit services (NAS) fees refer to fees paid to auditor for tasks beyond certification audit. Such payment is for services rendered neither to improvised financial statement, nor to the review services that are adapted in line with generally accepted auditing standards (GAAS). NAS fees may comprise payment for consultancy, tax assistance, SEC filing services, mergers and acquisitions support, and others. In general, NAS is required to improve operational transparency. It is argued that the NAS performed by auditors and its fees have been increasing significantly contributing towards audit firms' revenue and deemed to have substantially impaired auditor independence. This statement is reflected in Dhaliwal's et. al.,(2008) argument that Securities and Exchange Commission (SEC) further claimed that acquiring NAS may deteriorate auditor independence. Specifically, regulators are alarmed about two effects of NAS fees; (i) auditors became financially dependent hence appear to more likely unable to stand up to management pressure for fear of losing their client; and (ii) the consulting nature of many non-audit services put auditors at managerial roles, which may risk the objectivity nature of audit itself (Defond, 2002). Due to the fact, the SEC outlines new rule that prohibit auditors from engaging in certain NAS and require audit fees to be disclosed. These concerns are summarized in the following quote from the SEC regulations mandating fee disclosures (SEC [2000]):

....an auditor's interest in establishing or preserving a non-audit services relationship raises two types of independence concerns. First, the more the auditor has at stake in its dealings with the audit client, the greater the cost to the auditor should he or she displease the client, particularly when the non-audit services relationship has the potential to generate significant revenues on top of the audit relationship. Second, certain types of non-audit services, when provided by the auditor, create inherent conflicts that are incompatible with objectivity.'

As for Malaysia, the Malaysian Institute of Accountants (MIA) By-Laws (on Professional Conduct and Ethics)(revised 2002) recommended that auditors should not accept any appointment of provide NAS to their client due to impairment of professional independence, integrity and objectivity. In addition, Bursa Malaysia requires all

listed companies to disclose NAS fees in their annual reports effective from June 1, 2001. The main objective of this regulation is to safeguard the stakeholders' interests and at the same time improve their operational transparency. This practice is in agreement with other countries such as the US and Australia which had this requirement mandated even earlier.

2. Review of Literature

The relationship between audit fees and NAS has been discussed as far back as 1984. Simunic demonstrated a negative relationship exists due to exchange between audit fee and NAS. This is known as knowledge spillover effects where it flows from non-audit to the statutory audit side and vice versa. This economic bonding could, he noted, impair the auditor's independence. Another possible explanation of this negative relationship is that when auditing firms offer a variety of financial and non-financial planning to audits, in some situation NAS became more costly than audit work in dollar volume. By acquiring consultancy work, auditees view audit as "loss leader". These factors have tendency to perform audit task in shorter period which reduces the statutory audit fees. Subsequently, audit firms increase the NAS fees to capture the loss incurred in audit fee (Clatworthy et al., 2002). Likewise, studies that only found a negative relationship between audit fees and NAS fees were those Mellett and Peel (2002) and Fields et al., (2004). Clatworthy et al., (2002) investigated public sector organizations in the United Kingdom while Fields et al., (2004) examined banks in the United States.

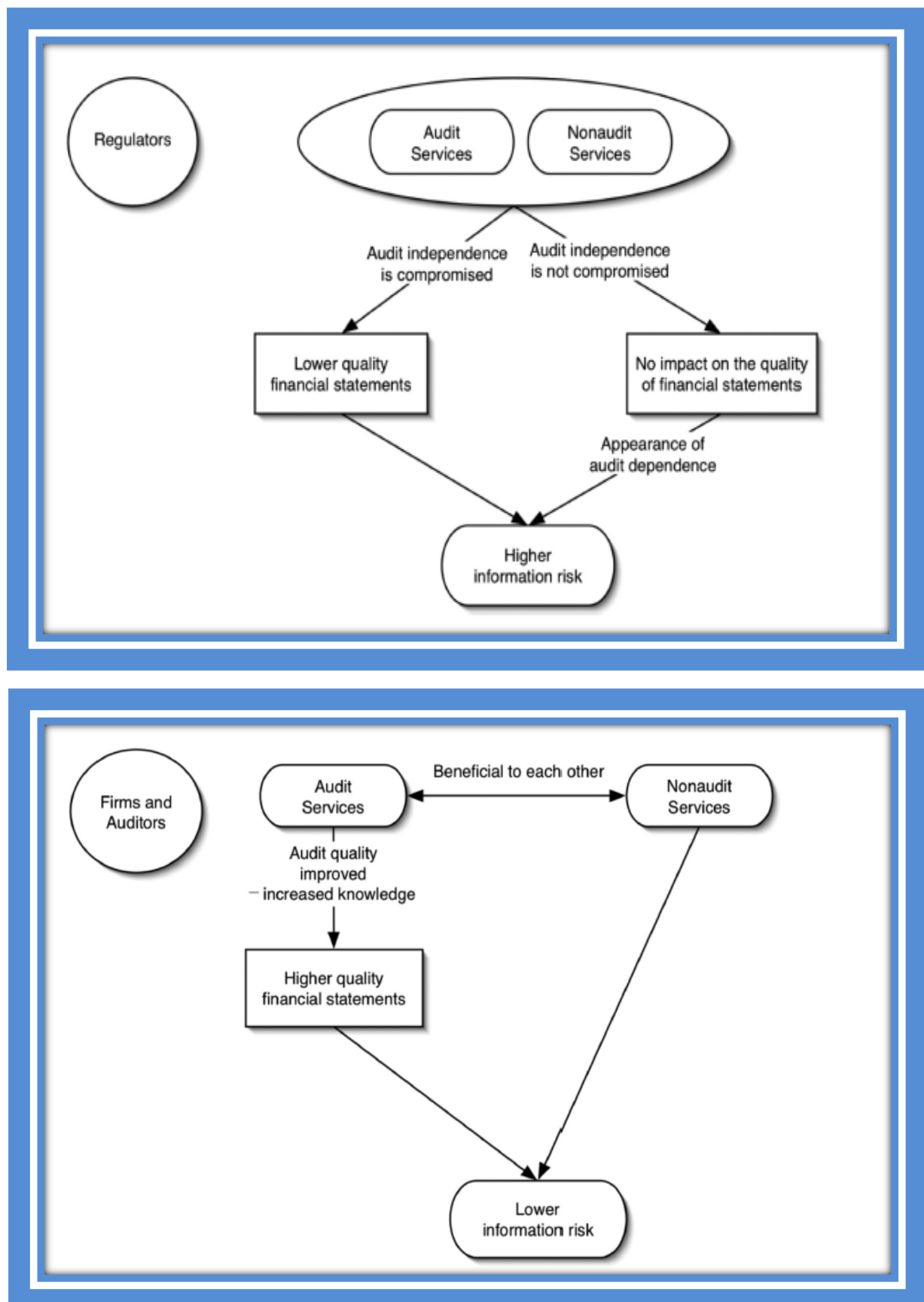
Prior studies by Firth (2002) evidenced that in United Kingdom, NAS has been a catchy services offered by the auditors over past years. This is supported by sterling rise since 1997 from 226m to Sterling 636m, at the same time ordinary audit remuneration has gone up from Sterling 186m to Sterling 212m (Cliff, 2002). This trends confirms that the auditees were purchasing NAS at an increasing rate along with audit service. This has revealed that while the NAS increased, the audit fees also marginally increased. Therefore, a positive relationship between audit fees and non-audit fees would be seen. Frankel et.al. (2002) forwarded similar results that NAS found to be positively associated by a very small margin. On the other hand, Krishnan and Yu (2011) concluded that non audit services; tax services fees found 1 percent increase in audit fees is associated with a 0.33 percent decrease in non-audit fees.

Litigation risks to some extent influences the fees paid as well. By focusing a market like Malaysia, litigation against auditors is almost unheard, as compared to litigation risk in the US. Therefore any cost associate with the further work demanded for qualification is more likely explanation. This is supported by Setharaman et al., (2002) and Nikkinen and Sahlstrom (2005) reported that litigation risks influence the degree of audit fees very much depends on country of litigation environment that an auditor operates. They conclude that more litigious situation lead to higher audit fee. Their results in general tie with the theory underlying Simunic (1980) and Simunic and Stein (1996) which audit fees reflect risk differences across legal responsibility regimes. Houghton and Jubb (1999) forwarded their argument that additional fees, either NAS or audit fees, are more likely to be billed on a qualified opinion than one receiving an unqualified opinion. It is further argued that the auditors may use NAS fees as a means of relieving market constraints imposed by factors such as audit fee tendering and fixed audit fee billing. An audit cost is likely recovered to be more problematic in situations involving qualified opinions than in those involving unqualified opinions. Hence, additional billing of auditor for an audit qualification is not earned through the audit fee alone.

On the other hand, there are several other studies on the relation between provision for NAS and audit quality, which found no relation and find no significant association between NAS fees and impaired auditor independence, thus no association between going concern opinions and either total fees or audit fees (DeFond et al., (2002). Defond further argue that the results are consistent with market-based incentives, such as loss of reputation and litigation costs, dominating the expected benefits from compromising auditor independence.

Scheiner et. al., (1982) found that over 50 percent of the companies pay over 10 percent of their audit fees for non-audit services. The prohibition of non-accounting, non-audit services would not appear to have a substantial impact on firms because these services do not represent large percentages of total fees. However, since these non-accounting non-audit services are not provided consistently by firms, the impact of any such prohibition would vary across firms. Chung and Kallapur (2003) failed to find any evidence on NAS and audit fees. Hence, the empirical evidence from many researchers remains elusive and mixed. Mixed view on NAS is explained in Figure 1.

Figure 1: Two Different Views on the Impact of Non Audit Services on the Quality of Financial Statements and Capital Markets



(Source : Seunghan, N. and Joshua, R., 2011).

Methodology

This study surveyed a total of 100 companies listed in Bursa Malaysia in 2010 under Industrial Product Sector. Selecting companies from same industry was to control for other factors which may contribute to variations. Findings presented herewith are based on selected secondary data of the listed companies and several short interviews with auditors.

3. Data Analysis

Bell et al., (2001) found NAS fees significantly, and negatively influenced audit fees in the U.S. Similarly, using Australian data (Butterworth and Houghton, 1995), and UK data (Craswell and Francis, 1999) find NAS directly influence audit fees too. Hence, a significant negative relationship between audit fees and NAS is expected in this study. This is consistent Malaysia studies done by Halil et al., (2012) and Che Ahmad et al.,(2006) which found that if shareholders believe that NAS reduce the reliability of financial statements, then the statutory audit fees should be lesser. It was also argued by prior researcher, negative relationship between audit fees and NAS occur due to tradeoff between audit fees and NAS (Simunic, 1984). In short, the skills, experience and knowledge which was used to doing consultancy services will be reuse during statutory audit in which may reduce cost of resources used and time saving, thus reducing the audit fees.

3.1 Empirical data

About 43% of selected sample did not record NAS fees in any page of annual reports. Terms used to define NAS fee in the annual reports were "Non-audit services fees", "Other audit fees "or "Non Statutory Audit". In order to increase effectiveness and efficient of an operation, and to regain appropriate management strategy to boost back competitive advantage of a company, shareholder may demand the board to take up NAS. An expert opinion is believed to bring back a company into profitability footing (Houghton and Ikin, 2001). This can be seen in Table 1, which shows that NAS increases with the level of revenue. However, an analysis as to whether NAS influences audit fee does not yield significant different.

Table 1: Relationship between NAS and Audit Fees					
Years		2010	2010	2010	2010
Total Revenue (\$ in Millions)	N	Avg Revenue in Millions	Avg Audit Fee in Thousands	Avg Non Audit-Fee in Thousands	Total Avg Fees in Thousands
10,000,000,000	1	5,057,773,000	832,000	208,000	1,040,000
5,000,000,000					
5,000,000,000	11	1,388,584,207	793,300	236,450	1,029,750
1,000,000,000					
1,000,000,000	8	691,711,084	262,338	30,075	292,413
500,000,000					
500,000,000	35	250,275,628	144,996	28,985	173,981
100,000,000					
100,000,000	39	53,693,908	88,545	20,583	109,128
10,000,000					
10,000,000	6	6,589,519	89,467	36,500	125,967
1,000,000					
(Notes: N=100; Source : Data extracted from Annual Report 2010, Bursa Malaysia website)					

Table 2: Multiple Regressions Result				
	Coeff	Std Err	t Stat	P-value
Intercept	1.0905	0.3938	2.7691	0.00680
LOGNAS	0.0214	0.0112	1.9053	0.05900
(Note : p-value of statistical significant at the 0.05 level; Adj R ² =0.677)				

The data is further regressed to observed relationship, as revealed in Table 2., NAS is found to not influenced audit fees paid in the surveyed companies. Similar to this study, Butterworth and Houghton (1995) found no relationship between audit fees and NAS too. Likewise, in Malaysian studies, Md Yusof & Che Ahmad (2000) argue that no statistical evidence to proof relationship between this two variable; NAS and audit fees.

This result, however, contradicts with Firth (2002), who derived to a conclusion based on a sample of 314 United Kingdom quoted companies, argued that, a NAS is demanded by a company and therefore additional audit effort is required. Auditors as external party expected to certify companies' financial statements would still need to put huge effort in delivering the trust bestowed upon themselves regardless of the NAS provided to the company by the same audit firms. However, in practice though, only audit firm which has completed their audit tenure will provide NAS to the company they previously certified. These stipulated in SEC regulation and thus reduce the crisis of independence.

3.2 Interview Responds

When question is asked whether auditors should publicly disclose and discharge their responsibilities on NAS, Respondent #1, #2 and #5 disagree with that statement. They argue that, this is not necessary in a market like Malaysia because so far they have not received any clear guideline for disclosure and moreover, the payment paid to auditors is already very low as compared to other countries. Several responses relating to these were;

“there are number of NAS offered by auditors such as taxation, transfer pricing financial services and etc. NAS is acquire to increase efficiencies of a company by saving the resources. This will not result in decrease in audit fees. If that happen, then the auditor independence will be questioned.” [Respondent #5].

“ whether to buy NAS or not, it depends on the directors discretion and board's approval, if they feel NAS could fix or upgrade the operation then we will buy that service, with the upgraded system audit work can be done on time and save cost.” [Respondent #4].

“if a company grow Bigger than probably they might need NAS, but this will not affect the audit fees charged NAS is acquired when the company decide to have it for better operation, therefore the fees is not necessary to break it down. After all the fees paid in Malaysia is very low.” [Respondent #2].

“Probably a separate disclosure is necessary if required by board in annual report otherwise it is not worth reporting since auditing profession is being underpaid.” [Respondent #2].

Majority, 60% respondents express their disappointment in Malaysian Institute of Accountants (MIA) which they believe should provide a clearer and reasonable guideline to deal with NAS requirements on the disclosure as well as pricing strategy for auditors to charge their client so that auditors' financial dependent on client can be reduced.

4. Conclusion

This study examines the relationship between provision for NAS fees and audit fees in the fee structure for external auditors. Finding from this study is relevant about the factor impacting audit fees and may help to established new studies related to it in near future. It is important from the regulatory perspective because of the SEC's and MIA's serious concern about auditor independence problem associated with increasing proportion of NAS consulting fee in the fee structure for external auditors. The empirical analysis of this study demonstrates that provision for NAS has insignificant impact on audit fees charged in Malaysia. Further research looking into the impact of (i) the audit fees, (ii) the audit quality, (iii) and the auditor independence on the clients would be beneficial.

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